Supreme Court, U.S.
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JOSEPH F. SPANIOL, JR.
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85-762 (1)

No. .....

In The
Supreme Court of the United States
October Term, 1985

THELMA T. METGE, Executrix of the Estate of August Metge, and ELIZABETH G. SHEPARD, on behalf of themselves and on behalf of all others similarly situated,

Cross-Petitioners,

vs.

BANKERS TRUST COMPANY,

Cross-Respondent.

CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

(Cross-Petition to No. 85-555, October Term, 1985)

W. Don Brittin, Jr.
Gerald J. Newbrough
Kasey W. Kincaid
Nyemaster, Goode, McLaughlin, Emery & O'Brien, P.C.
Tenth Floor Hubbell Building
Des Moines, Iowa 50309
(515) 283-3100

Attorneys for Cross-Petitioners

COCKLE LAW BRIEF PRINTING CO., (800) 835-7427 Ext. 333

23 PP

QUESTION PRESENTED

DOES SECTION 20(a) OF THE SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C. § 78t, REQUIRE THAT AN ALLEGED CONTROLLING PERSON ACTUALLY *EXERCISE* CONTROL OVER THE *GENERAL OPERATIONS* OF THE PRIMARY VIOLATOR, OR IS SUCH CONTROL OVER GENERAL OPERATIONS ONLY ONE ALTERNATIVE INDICIA OF THE REQUISITE *POWER TO CONTROL* THE PROSCRIBED ACTIVITY?

PARTIES TO THE PROCEEDINGS

Plaintiffs named in the caption in this case are representing themselves and a class of approximately 635 individuals similarly situated which has been certified by the district court. The Appendix hereto contains a list of the members of the Plaintiff class.

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OPINIONS BELOW

The opinion of the Court of Appeals is reported at 762 F.2d 621 (8th Cir. 1985), and the opinion of the district court is reported at 577 F. Supp. 810 (S.D. Iowa 1984). Both opinions are reproduced in the Appendix to BTC's petition for certiorari.

JURISDICTION

The judgment of the Court of Appeals was entered on May 15, 1985, and Plaintiffs' petition for rehearing was denied on July 5, 1985. Jurisdiction in the District Court is invoked under 15 U.S.C. § 78aa. Jurisdiction in this Court is invoked under 28 U.S.C. § 1254(1).

This cross-petition is filed under Supreme Court Rule 19.5, and is a cross-petition to the petition for certiorari in *Banker's Trust Company v. Metge,* October Term 1985, No. 85-555, filed on September 27, 1985, and received by Plaintiffs' counsel on September 30, 1985.

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

15 U.S.C. § 78t provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally and to the same extent as such controlled person to any persons to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

17 C.F.R. § 230.405 provides in pertinent part:

> The term "control" . . . means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

STATEMENT OF THE CASE

This matter is a class action filed on behalf of the holders of certain securities ("Thrift Certificates" and "Thrift Certificate Guarantee Bonds") against the officers and directors of the issuers, Investor's Equity, Inc. ("IEI") and Investors Mortgage and Finance Co. ("IMF"), and against Bankers Trust Company ("BTC"). Plaintiffs allege BTC is secondarily liable as an aider and abettor and as a "controlling person" under section 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t. In an opinion filed May 15, 1985, the Court of Appeals reversed the district court's entry of summary judgment in favor of BTC on the aiding and abetting claim, but affirmed summary judgment on the claim of controlling person liability.

The facts in this case are complicated and voluminous. Because Plaintiffs rely in part upon permissible inferences and circumstantial evidence, it is necessary to state the facts in more detail and with more accuracy than does BTC in its petition for certiorari (No. 85-555). Plaintiffs have done so in the Statement of Facts at pp. 2-11 of their Brief in Opposition to BTC's petition, filed contemporaneously herewith. Rather than burdening the Court by repeating the facts here, they respectfully refer the Court to said Statement of Facts.

REASONS FOR GRANTING THE WRIT

SECTION 20(a) OF THE SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C. § 78t, DOES NOT REQUIRE THAT THE ALLEGED CONTROLLING PERSON ACTUALLY EXERCISE CONTROL OVER THE GENERAL OPERATIONS OF THE PRIMARY VIOLATOR AS SUCH CONTROL OVER GENERAL OPERATIONS IS ONLY ONE ALTERNATIVE INDICIA OF THE REQUISITE POWER TO CONTROL THE PROSCRIBED ACTIVITY.

Plaintiffs' claim of controlling person liability is based upon section 20(a), 15 U.S.C. § 78t, which provides:

> Every person who, directly *or indirectly*, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally and to the same extent as such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. (emphasis supplied).

The concept of "control" under section 20(a) is defined by administrative regulation:

> The term "control" . . . *means the possession, direct or indirect, of the power to direct or cause the direction* of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. (emphasis supplied).

17 C.F.R. § 230.405.

Consistent with the SEC definition of control and the plain language of the statute, the courts of appeals have

generally concluded that the *power to control* or influence the affairs of the primary violator, as opposed to the *actual exercise* of control, is sufficient. *E.g., G. A. Thompson & Co. v. Partridge,* 636 F.2d 945, 957-58 (5th Cir. 1981) (*quoting* SEC definition); *Gould v. American-Hawaiian Steamship Co.,* 535 F.2d 761, 779 (3d Cir. 1976); *Rochez Brothers, Inc. v. Rhoades,* 525 F.2d 880, 890-91 (3d Cir. 1975), *cert. denied,* 425 U.S. 993 (1976) ("the courts have given heavy consideration to the power or potential power to influence and control the activities of a person, as opposed to the actual exercise thereof"); *Richardson v. MacArthur,* 451 F.2d 35, 41-42 (10th Cir. 1971). Even the Eighth Circuit has recognized that evidence of the power to control, as opposed to the actual exercise of control, is sufficient:

> The statute is remedial and is to be construed broadly. It has been interpreted as requiring *only some indirect means of discipline or influence short of actual direction* to hold a controlling person liable.

Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968) (emphasis supplied).

In reviewing the district court's grant of summary judgment in favor of BTC on the controlling person claim, the Court of Appeals focused on the appropriate legal standard for "control" and whether the record presented a factual issue under that standard. The court specifically adopted a new two-pronged test for control devised by the district court.

> [T]he district court formulated a two-point test under which plaintiffs must establish, first, that the defendant lender "actually participated in (*i.e., exercised* control over) the operations of the corporation in

> general; then he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that this later power was exercised.

Metge v. Baehler, Appendix to No. 85-555 at A-17, 762 F.2d at 630-31 (*quoting* 577 F.Supp. 810, 817-18 (S.D. Iowa 1984) (emphasis in original)). Focusing on the first prong of this test, the Court of Appeals concluded Plaintiffs had failed to introduce "sufficient evidence of [IFC]'s actual control over IEI's general affairs", Appendix to No. 85-555 at A-18-19, 762 F.2d at 631-32, and therefore affirmed the entry of summary judgment.

The definition of control adopted by the Court of Appeals directly conflicts with both the decisions of other circuits and the SEC definition of control. It requires a showing greater than the defendant's possession of the power to control the primary violator; it requires that plaintiffs demonstrate that the defendant actually exercised control over the general operations of the primary violator. Under this standard, only after this first prong has been satisfied can attention be focused on whether the defendant had the power to control the proscribed activity (the second prong).

By requiring plaintiffs in all cases to prove that the controlling person actually exercised control over the general operations of the primary violator, the Eighth Circuit goes well beyond the decisions of other federal courts. It negates and emasculates the generally recognized principle that the power to control is sufficient to establish a prima facie case of control. In fact, because the violating conduct is necessarily part of the broader general oper-

ations of the company, the court's opinion requires not only exercise of control over general operations but also, by implication, *exercise* of control over the violation itself. These direct conflicts between the Court of Appeals decision and the test enunciated by the other circuits, as well as the SEC definition, warrant plenary consideration by this Court.

The Eighth Circuit's restrictive standard also conflicts with section 20(a), its legislative history and underlying policies. In enacting this provision, Congress declined to adopt an explicit definition of control, intending instead that the concept remain adaptable. "It was thought undesirable to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which control may be exerted." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 26 (1934). This express congressional recognition that control arises in a myriad of factual circumstances and may be demonstrated by numerous factors necessitates the examination of a variety of indicia which may evidence the power to control in any given case. *See, e.g., Rochez Brothers, Inc. v. Rhoades,* 527 F.2d at 890 (omission of definition of "control" indicates congressional desire to have courts construe the statute along with evidence adduced at trial). As noted by former SEC Commissioner Sommer:

> [I]t has become axiomatic that in deciding who is a "controlling person" the entire situation within the corporation at the time of determination, together with some of the history of the corporation, must be considered; single factors—shareholdings, offices held, titles, conduct—are rarely determinative, at least not in the close cases. . . .

Sommer, *"Who's In Control?"—SEC,* 21 Bus. Law. 559, 563 (1966). Consistent with this mandate, the federal courts have recognized that proof of the power to control can be demonstrated by different factors in different cases.

By requiring proof of the actual *exercise* of control by a defendant over the *general operations* of the controlled entity, the Eighth Circuit has, in effect, redrafted section 20(a) and turned one of the several alternative indicia of the power to control the primary violation—the actual exercise of control over general corporate operations—into a condition precedent which must be satisfied in all cases before a prima facie case of control can be established. By focusing on one factor indicative of the power to control to the exclusion of all others, the court has severely restricted the availability of controlling person liability, effectively emasculating the remedial goals of section 20(a) and the broad and liberal construction it was intended to be afforded. The court's narrow approach to control is in direct conflict with Congress's intent that the concept of control remain adaptable and subject to proof by a variety of means depending upon the facts of the particular situation.

Exercise of actual control over the general operations of a corporate entity is only one means of proving the power to control. The status or position of the defendant is also of significance. For example, status as a majority shareholder or as a long term, active director would be probative of the power to control, and, indeed, has repeatedly been recognized as such. *See, e.g., Klapmeier v. Telecheck International, Inc.,* 482 F.2d 247, 256 (8th Cir. 1973). In the present case BTC's power to control is evi-

dent by its status. BTC was by far the largest shareholder of IEI, the primary violator; it concealed its IEI stock and attendant shareholder powers in a nominee company; it held an irrevocable and absolute proxy to vote the shares of Mid-Iowa Lakes Corp., IEI's largest operating subsidiary and repository for most of its assets; it was IEI's primary lender in connection with large loans that were regularly in default; its loan documents gave broad and unusual powers over IEI's capital structure and operation; IEI's principal officers and directors were beholden to BTC as guarantors of a large obligation they could not afford to pay; and BTC had a long and unusually close association with IEI's principal officers and directors.

Conduct short of actual participation in the primary violator's general operations can also be evidence of the requisite power to control. In this case, BTC voted its block of IEI stock by giving its proxy to management; it directed loan re-papering and inter-company transactions for its own benefit; it closely monitored IEI's financial situation; it met and counseled with IEI's principals on a frequent basis; it helped IEI get financing for its subsidiaries; it helped it look for other financing; it helped IEI issue Thrift Certificates to other creditors (Triple-Eye noteholders); it helped IEI collect its receivables; it attended some IEI and MIL board meetings; in the words of the Eighth Circuit's opinion, it participated in "an unusual pattern of extraordinary attempts to prolong IEI's financial viability", and on several occasions it "rescued IEI and its subsidiaries from the brink of financial disaster". Despite conceding that the record evidence "exemplifies the kind of evidence that might be adduced on the second prong of the test to demonstrate possession of

power to control," Appendix to No. 85-555 at A-19, 762 F.2d at 632, the Eighth Circuit rejected this evidence as a matter of law on the ground that the facts do not support a finding that BTC actually *exercised* control over *general corporate affairs* as required by the first prong of its test. This requirement is unduly narrow and restricts the applicability of section 20(a) in direct conflict with congressional intent.

The Eighth Circuit's restrictive requirement of actual control over general corporate operations further frustrates the policy underlying section 20(a) by exonerating persons who possess the power to control a primary violator, or who actually exercise control over the violation, but who have not exercised control over general operations. The policy predicate of section 20(a) is apparent: persons with the power to control primary violators may be held secondarily liable for failing to stop or prevent the violations from occurring. While such persons are not insurers, and have available statutory defenses of good faith and non-inducement as means of avoiding liability, Congress has determined that the risk of loss for securities violations will rest not only with the primary violator but also with those persons who possessed the power to prevent the violation. Thus, proof of possession of the power to control is sufficient to generate a prima facie case and shift the burden to the defendant to prove its good faith and non-inducement of the violation. To hold otherwise, as the Court of Appeals has done, precludes the imposition of secondary liability upon a person who, by whatever means, possessed but declined to exercise the power to control the general operations of the controlled entity.

By requiring proof of the actual exercise of control as a precondition to establishing a prima facie case under section 20(a), the Court of Appeals has engrafted an element of proof that is not required by the statute. Far from effectuating the purpose of section 20(a), the narrow reading of the Court of Appeals instead eliminates its applicability in a large number of situations where Congress intended it should apply. Congress's deliberately expansive language and broad approach to the problem of secondary liability, as well as its express command that the statute be read broadly, demonstrate the fallacy of the Eighth Circuit's unsupported interpretation. *See Sedima, S.P.R.L. v. Imrex Co.*, 53 U.S.L.W. 5035, 5039 (U.S. No. 84-648, July 1. 1985).

The significance of the Eighth Circuit's decision is further heightened by the context in which it arose. This case involves the application of controlling person principles to a defendant that was the largest shareholder and primary lender of the violator. Although the Court of Appeals did not limit its restrictive approach to control to cases involving only lender defendants, the opinion will generate substantial confusion and conflict in lender liability cases. Previous decisions involving lender liability under section 20(a) have not found it necessary to modify accepted standards and defintions to protect lenders. The conflict and confusion resulting from the Eighth Circuit's decision present questions of exceptional importance deserving of the plenary consideration of this Court.

CONCLUSION

By requiring proof of the actual exercise of control over general corporate operations as an absolute prerequisite to controlling personal liability under section 20(a), the Eighth Circuit's opinion directly conflicts with the well reasoned conclusions of numerous other circuits that only some indirect means of influence "short of actual direction" is required. The Eighth Circuit's definition of control also conflicts with the administrative definition of that term and with Congress's express intent that the statute be interpreted liberally to allow proof of control by a variety of means. The Court of Appeals has adopted a narrow and restrictive definition that effectively precludes proof of the power to control by any means other than the actual *exercise* of control over *general* corporate operations. As a result, it limits the applicability of the statute by excluding from its coverage some persons who possess but do not exercise the power to control and some persons who exercise control over the violation but who do not exercise control, though they may possess it, over general operations. The inevitable conflicts and confusion resulting from the Eighth Circuit's decision present substantial legal issues of national significance and warrant plenary consideration by this Court.

Respectfully submitted,

W. Don Brittin, Jr.
Gerald J. Newbrough
Kasey W. Kincaid
Nyemaster, Goode, McLaughlin,
Emery & O'Brien, P.C.
Tenth Floor Hubbell Building
Des Moines, Iowa 50309
(515) 283-3100

Attorneys for Cross-Petitioners

Dated: October 28, 1985

APPENDIX

Parties to the Proceeding—Identified Members of Plaintiff-Class

Mrs. Lorrene Adair, James F. Adams, Agnes M. & William A. Adix, Carolina F. Seeley, Robert L. Alexander, Allen A. or Christine Anderson, Frank or Elna Anderson, Jeffrey or Barbara Anderson, Roger F. Andersen, Paul D. Anneberg, M.D., Henry or Zinita Anton, Dr. Kashmiri L. Arora, Arthur or Alyss Babcock, Betty Ruth Babcock, Oscar H. Baehler, Arnold L. Baier, Ludwig or Edna Balcer, Norman and Geraldine Ball, Dennis & Linda Barber, Halsted W. & Pat Barber, Mary Barnard or Marcia E. Harper, Timothy S. or Gertrude T. Barry, Donald & Esther Barr, Agnes I. Bass or Carol M. Arnold, Madhuri Jayant Belsare & Jayant Vishnu Belsare, Gary or Susan Bennerotte, Molly Rene, Bruce O., Jr. and Ann Bentley, Laura L. Bentley, John H. & Janet E. Berns, Mrs. Zella Bickelhaupt, Steven or Frederick Bierhaus, Lucinda Bierstedt, Donald L. or Nancy M. Blanchard, James Block, Mervin Blythe, Myrna L. Boggs, Leo C. or Ella Boland, Wayne F. Borck, Irma or Orland Boyle, Frank or Hazel Brady, Mildred Branderhorst, Bernard D. Brannan, Lyle or Sondra Broer, Urith Broff, Edward B. & Marie M. Brommel, Wayne or Helen Brooker, Edwin M. Lyle Bruere, Thomas J. Bryant, C.D. or V.V. Buckley, Clayton A. Burgardt, T. Allen & Edna Burke, Robert M. or Betty Burns, Michael T. Camacho, J.K. or Doris Campbell, William H. Cansdale, Sr., Obert F. or Jeanette Chalstrom, Norma J. & Mabel Chapman, Roy F. Christians, LaVerna Christiansen, Helen B. Clark, Ross H. Clark, Mrs. Edwin Clarkson, John J. Cole, James or Shirley Conner, Mrs. Ruby Coonradt, W.R. or Frieda

Cormicle, J. W. or Wm. G. Cox, Frieda E. or Robert Crane, Robert N. or Evelyn Croden, Mrs. Linda L. Currie, Wayne W. or Marion Daggy, Jerry W. Dahlhe, Ivan Dahlem & Pat Egelhof, William or Engelena Damstra, Burdette Davis, Marion E. Bale Davis, Ralph W. or Reva E. Dawson, Russell W. or Bernice Day, Mr. & Mrs. Paul DeBruin, Alfred & Cathryn DeDoncker, Virgil C. DeGrotte, Paul E. or Betty DeLapp, Walter and Grace Dethlefs, William or Agnita Detterman, Christine DeZeeuw, Mrs. Elizabeth Dillon, Bernard and Mary Dombeck, Oran D. or Juanita Dow, William & Maxine Duff, Florence Dundee, Mr. or Mrs. D.D. Dunlavy, Edward or Charlotte Dvoretzky, Carlene Dyer, Lyle R. or Colleen Eich, W. B. Elderbroek, Arlie Elliott, John H. Eppink, Vance or Wanda Erickson, Mrs. Rachel R. Eustler, Ivan L. & Helen Everett, Henry P. or Dora Feldman, Derwin & Elsie Ferry, J. Claire Fitzgerald, Richard J. Floyd, Romanus A. or Mary Fogarty, Jack E. or Helen Fogelson, P. L. Fotsch, Arthur H. or Emily Frederick, Peter J. or Jeanne Frederick, Berneice Friesz, Karen Fullenkamp, Alice M. Funk, Patricia Gants, Bill J. & Lee Gamertsfelder, Mrs. Glenn G. Gardner, Leland C. or Martha Geiger, Henry R. Gelski, Mrs. Jeanne O. Giles, Stephen A. or Mary E. Gilman, Genevieve C. Goetz, Trustee for Louis Goetz, Ruth M. Goff, Chester W. or Irene A. Good, Simon Clifford & Flossie May Graham, Madonna R. Green (Molitor), Robert Green, John F. Grell, Wendell S. or Lucile A. Griffiths, Ed Gross, Joseph J. or Victor W. Grossman, Roger & Ruth Grove, Andrew L. or June A. Grovo, M. Irene Guerrero or Darlene G. Coleman, Earl & Marlene Guler, Donald L. or Delores A. Hadenfeldt, Benjamin H.H. Hang or Flora I. Hang, William J. or Harvey E. Hanna, Gertrude H. Hansen, Otis J. or Leone B. Hanson or Carrie M. Reinertson, Richard or Elaine Harlow, Jack

or JoAnn Hartle, David E. & Ruby L. Hartsook, Gladys A. Hatch, Onno Heidebrink, F. A. Hellenthal, Ray J. Hemesath, Nova F. or Marceline B. Henderson, Urban Hermsen, T. W. Hile, William Eugene Hill, Mrs. Esther Hindman, Douglas L. Hiple, Max Hoben, Lambert M. or Loretta Hoeger, Carol May Hoff, Daniel K. Hofman, C. Edwin or Angeline S. Hogan, Dean A. or Pamela D. Hoganson, Vera M. Holm, Clarence T. or Helen M. Holub, Lowell M. or Marjorie A. Honson, Olive A. Hooker, Virgil C. or Leona C. Hougen, John M. or Kala M. Houlette, Gerald Paul & Mary E. Houser, Helen V. Housh, James E. & Gladys Howard, Mildred M. & Fritz Hug, Harlan S. & Marlys M. Hughes, Frank E. Ireland, Hubert Ireland, Leonard Jackson, Mrs. Esther J. Jacobsen, Michael L. or Eischen Jensen, Edith G. or Emmert M. Jensen, Leo N. or Leona Jessen, Gayl W. or Mary E. Johnson, Gene C. Johnson or Beulah Hoover, Herman or Adeline Johnson, William J. Kanne, Hilda Heleher or Charlotte Kramer, Mrs. Bernice Kelley, Don C. King, Vithal M.D. Kinhal, David K. Kirkpatrick, Margaret A. Klocke, John & Elvera Kotrba, James L. Kritz, W.G. or Helen A. Kitzman, John P. or Agnes A. Kivlin, Wayne & Ella Kuehnhold, Herman G. & Helen A. Kutz, Clarence J. Lacey, Conservator for Kevin John, Frederic S. Lacroix, Arthur E. Ladwig, John E. or Dolores J. Lahey, Mrs. Martha Lankford or Connie Baker, Orville & Robert Lanham, Mrs. M. N. Laursen, C.R. or Ruth C. Lawler, Allan P. or Deanna R. Lehl, Lola H. Lein, Esther I. Lindskoog, William L. & Beverly G. Link, Nadine Liston, Guy, Jr. and Letha H. Littell, Loren R. Little, Richard S. or Priscilla D. Lorber, Ernest or Lydia K. Lollar, Brent W. Loring, Gerritt or Mabel Lourens, Harold or Esther Loynachan, Mrs. Ethel Lubke, Karl Frederick Ludwig, Theresa or Dorothy Lydon, Robert R. & Martha J. Lynn,

Carl N. or Lola M. Machande, Aarti Madan, Victor Maeschen, Timothy T. Maifeld and Ronald and Judy Maifeld, D.W. or Martha Malmstedt, Vernon D. & Virginia M. Marine, Leo or Zella Mathena, Duane & Ivanelle Matt, Josie McCurdy or Lyda Leanhart, Derrill & Wendy McDanel, Wm. H. & Hazel A. McClurg, David N. & Nancy McConnell, Claude McCullough, Mildred McIntosh, Lowell E. & Delores J. McKenzie, Rudolph McNee, Kenneth or Mildred McWhinney, Gladys Mae Meier, Jans T. Mennenga, Alfred A. or Lola T. Meredith, August Metge, David J. Michael, Esther Mickesh, Fred W. or Lydia A. Miller, Roy E. or Beulah R. Miller, Harry A. & Grace E. Moldenhauer, Mildred Montgomery, Dwayne K. or Thelma L. Moorhead, Elmer or Irene Morrison, Leighton R. Morse, Michael J. Murphy, Ruby or Gerhard Myers, Roy or Harriett A. Neal, Lewis W. & Stacia A. Newell, Wilford G. & Marilee Niedermann, Joseph P. or Thelma M. Nockels, Stan Norenberg, Clarence L. Norman, Gary L. or Saundra R. Nyhus, Frank B. Oetker, Ellis C. or Gertrude Oldham, Richard D. Olson, James R. & Rodney W. Olson, James M. or Wilma A. O'Rourke, Robert Ray Padgett, Glen D. Parker, Frank or Phyllis L. Pascuzzi, John B. & Ruth Pannuk, Glenn or Lola B. Patterson, Judson D. & Ethel M. Patterson, Helen I. or Willard F. Paulsen, Russell Paulsen, Mildred or Lester Pearl or Sheila Johnson, Peter J. or Darlene D. Pelofske, Howard Penny, Wilbur S. & Edna May Perkins, Kenneth M. or Minnie V. Perry, Troy L. Pestel, Leslie M. Peterson, Louis Peters, Paul Peterson, E. L. & Myra L. Pettenger, Bion L. Pierson, Thomas J. Pitzen, Mrs. Marie M. Pohlen, Robert N. & Bonnie J. Polson, Orin E. or Mary Pratt, Donald A. or Lila K. Price, Joseph M. or Leone C. Pulver, Henry C. Rath, Alfred E. & Katherine L. Rau, Esther E. Reed, Clayton Reed, M.P. & Illiene M. Reed,

Florence M. Reedy, R. S. Renshaw, John C. Rice, Raymond F. Rick, Mark Rogness, Lucille Rolwes, Karen R. Rowedder, George Rumbaugh, Mrs. Antonia Ryken, Arnold M. or Alma M. Sampson, M. A. Sargeant, Ferne L. & Wanda Sarver, Carl E. or Jean E. Scheib, Mary Ann Schlichte, Mrs. R. J. Schliekelman, Ollie or Florence Scholz, Peggy A. or Lester L. Schreiner, Henry or Amanda Schultz, Donald W. or Eloise J. Schultz, Leo C. Schumacher or Mrs. H. H. Thorup, Ernest Schwartz, Herbert M. or Walter W. Shute, Sigma Tau Gamma, Alpha Eta Chapter, University of Northern Iowa, Lloyd Sinram, Robert J. Skelton, Ted P. Sloane, Martha Sobieski, Mr. or Mrs. Martin J. Solheim, Pauline M. Spencer, Edward or Erma Stahlhut, Keith D. Steffens, Donald D. & Donna R. Stevens, Mrs. Richard C. Strachota, Robert Strutt, Robert A. or Arlene J. Sundell, William D. & Ruth M. Sutherlin, Charles L. or Barbara A. Swanson, Sophie or DeRonda Taggart, H. A. Tague, Roger & Norma Thede, Eugene R. or Mayvis E. Thelen, George H. Thinnes, George H. Thinnes, c/o William Thinnes, J. or W.A. Thomas, Lawrence J. Traeger, Louis E. Transo, Louis E. Transo, c/o Charlotte E. Johnson, Allen B. Trimble, Roger A. Turnquist, Roger L. & Barbara Tuttle, Harold A. or Adeline Varce, Henry Van Dusseldorp, Clarence A. & Luella M. Van Engelhoven, Jeanne Van Nimwegen, Harold D. & Harriett Van Zante, Gordon F. or E. Berneice Voigt, Ethel R. Wagner, Hollis or Lucille Wainscott, Mrs. Elnora S. Wald, Kenneth M. Wald, Joe Walk, c/o Marvin Walk, Mrs. Mary E. Wallace, Violet M. Wallner, Florence M. or Wray L. Walter, Rita M. or Ceceilia M. Walter, Melba I. Weber, Willard or Ruth Wells, B. S. or Gladys E. Westlake, J. J. Weyer, Don or Edna Wheeler, Dale L. or Reva M. White, Myron White, William P. Wideman,

Philip G. & Mary C. Wieting, George Wight or Varguerite Bek, Melvin V. & Zona Wilhite, John O. & Martha Wingert, Ronald R. or Beulah I. Woodin, Joe D. or Nadine R. Woods, DeRoy J.D. & Jacqueline J. Wunderly, Jeffrey B. or Jerri Young, Robert D. or Kathryn S. Zartman, Mr. and Mrs. Richard Zellaha, Leonard Zotzmann, or their successors in interest.

Supreme Court, U.S.
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No. 85-762

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

THELMA T. METGE, Executrix of the Estate of August Metge, and ELIZABETH G. SHEPARD, on behalf of themselves and on behalf of all others similarly situated,

Cross-Petitioners,

vs.

BANKERS TRUST COMPANY,

Cross-Respondent.

On Cross-Petition For A Writ of Certiorari to the United States Court of Appeals For the Eighth Circuit (Cross-Petition to No. 85-555, October Term, 1985)

BRIEF OF CROSS-RESPONDENT BANKERS TRUST COMPANY, IN OPPOSITION

BENNETT A. WEBSTER
ROBERT A. GAMBLE
KAREN J. LAMP
GAMBLE, RIEPE, WEBSTER, DAVIS & GREEN
2600 Ruan Center
Des Moines, Iowa 50309
(515) 243-6251

Attorneys for Cross-Respondent, Bankers Trust Company

St. Louis Law Printing Co., Inc., 411 No. Tenth Street 63101 314-231-4477

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QUESTION PRESENTED

WERE THE DISTRICT COURT AND THE EIGHTH CIRCUIT COURT CORRECT IN HOLDING THAT THERE IS NO GENUINE ISSUE OF MATERIAL FACT THAT THE BANK (BTC) WAS A CONTROLLING PERSON OF THE PRIMARY VIOLATOR WITHIN THE MEANING OF § 20(a) OF THE SECURITIES EXCHANGE ACT, 15 U.S.C. § 78t?

PARTIES TO THE PROCEEDINGS

A Statement Relative to Rule 28.1, parties to the proceedings on behalf of Cross-Respondent, Bankers Trust Company, is set forth in the Petition for Writ of Certiorari of Petitioner, Bankers Trust Company, docketed in this Court on September 27, 1985, as No. 85-555.

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No. 85-762

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

THELMA T. METGE, Executrix of the Estate of August Metge, and ELIZABETH G. SHEPARD, on behalf of themselves and on behalf of all others similarly situated,

Cross-Petitioners,

vs.

BANKERS TRUST COMPANY,

Cross-Respondent.

On Cross-Petition For A Writ of Certiorari to the United States Court of Appeals For the Eighth Circuit (Cross-Petition to No. 85-555, October Term, 1985)

BRIEF OF CROSS-RESPONDENT BANKERS TRUST COMPANY, IN OPPOSITION

Cross-Respondent, Bankers Trust Company, respectfully opposes the Cross-Petition for Writ of Certiorari by Cross-Petitioners to review the judgment of the United States Court of Appeals for the Eighth Circuit.

OPINIONS BELOW

The Opinion of the Court of Appeals is reported at 762 F.2d 621 (8th Cir. 1985), and the opinion of the District Court is

reported at 577 F. Supp. 810 (S.D. Iowa 1984). Both opinions are reproduced in the Appendix to Bankers Trust Company's Petition for Writ of Certiorari filed with this Court on September 27, 1985.

JURISDICTION

See Petition for Writ of Certiorari filed by Bankers Trust Company, at page 2.

STATUTES AND REGULATIONS INVOLVED

See Petition for Writ of Certiorari filed by Bankers Trust Company, at pages 2-3.

STATEMENT OF THE CASE

The Bank adopts the first paragraph of Cross-Petitioners' Statement of the Case, pursuant to Sup. Ct. R. 34.2.

STATEMENT OF FACTS

Plaintiffs' Cross-Petition for Writ of Certiorari on the question of controlling person liability relies upon the Statement of Facts contained in the Brief in Opposition to the Bank's Petition for Certiorari. The first four pages of that Brief (pp. 4-7) relate to events which occurred long before the Bank loans here involved and which primarily involve dealings of the Bank with the Woodland Corporation, a corporation wholly unrelated to any of the parties in this case. These facts are completely irrelevant to the issue of control. Plaintiffs continue the recital of alleged facts which occurred after May 10, 1974, when sales of the Thrift Certificates had ceased and even after the bankruptcy of IEI. (Pp. 18-19). These facts are irrelevant, as no violation was occurring. Plaintiffs' Statement of Facts is not supported by the record and alleges that the Bank did not lose money on the IEI loan (p. 20). Plaintiffs did not make this assertion in the District Court or in the Eighth Circuit, and it is contrary to the Findings of Fact of the District Court. (Ap. B, A-24).

Chief Judge Stuart accurately set forth and facts relative to alleged control person liability and these are largely repeated by the Eighth Circuit. Plaintiffs rely upon ordinary restrictive covenants in term loan agreements (boilerplate), such as are used by all banks, and upon facts which occurred after the violation had ceased. Plaintiffs rely upon covenants which require the Bank's permission for additional borrowing in excess of $100,000, which restrict the payment of dividends, sale of capital assets and similar ordinary term loan covenants. These, of course, are not indicia of "control", and if so would make every banker-lender a controlling person.

Plaintiffs rely primarily upon events which occurred several months after the sale of Thrift Certificates ceased on May 10, 1974. On pages 18 and 19 of their Brief in Opposition they recite these facts which are, of course, wholly irrelevant to the issue here presented. Judge Stuart correctly found that in order to be liable under § 20(a) that the alleged controlling person must be in control *at the time of the violation* and not at some other time. The Bank was not in day-to-day contact with IEI or its officers. It attended one board meeting of IEI immediately before May 10, 1974. All of IEI's officers and directors testified in detail that the Bank did not concern itself with the day-to-day operations of the company and was not in control either of the Thrift Certificate program or of the corporation itself. These facts are uncontradicted as Judge Stuart found. Even accepting Plaintiffs' Statement of Facts at face value, there can be no Bank liability as a controlling person for the reasons stated by the District and Circuit Courts.

REASONS FOR AFFIRMING THE DISTRICT AND CIRCUIT COURTS

This Court should grant certiorari both as to the aiding-abetting and controlling person aspects of this case, matters which have not heretofore been considered by this Court, but should affirm the District Court and Eighth Circuit Court of Appeals on the question of controlling person liability and reverse on the question of aiding-abetting.

ARGUMENT

The District Court And The Eighth Circuit Court Were Correct In Holding That There Is No Genuine Issue Of Material Fact That The Bank (BTC) Was A Controlling Person Of the Primary Violator Within The Meaning Of § 20(a) Of The Securities Exchange Act, 15 U.S.C. § 78t.

In their Cross-Petition for Certiorari plaintiffs criticize the rule for controlling person liability formulated by Chief Judge Stuart and adopted by the Eighth Circuit. In fact, Judge Stuart having found two different views of a "control person" in the Circuits, adopted the view most favorable to the plaintiffs. The Second and Third Circuits have adopted the "culpable participation rule" - that an alleged controlling person cannot be liable unless he culpably participates in the primary fraud. *Rochez Brothers, Inc. v. Rhoades,* 527 F.2d 880, 889-892 (3rd Cir. 1975); *Gordon v. Burr,* 506 F.2d 1080, 1085-1086 (2nd Cir. 1974). The Ninth Circuit follows a similar view, holding that the controlling person must have at least participated in the activities giving rise to the violation. *Christoffel v. E. F. Hutton & Co.,* 588 F.2d 665, 668 (8th Cir. 1978). *See* 577 F. Supp. 815. Since Judge Stuart's opinion, the Ninth Circuit has adhered to this view in *Burgess v. Premier Corp.,* 727 F.2d 826, 832 (9th Cir. 1984). Judge Stuart found this view unnecessarily burdensome to plaintiffs and held that proof of culpable participation or participation in the activities which gave rise to the violation

is unnecessary. He noted that the Fifth Circuit had rejected this view in *G. A. Thompson & Co. v. Partridge*, 636 F.2d 945 (5th Cir. 1981), holding that lack of participation and good faith are affirmative defenses under the statute (citing cases in accord, p. 816 including *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977) and *Holloway v. Howerdd*, 377 F. Supp. 754 (M.D. Tenn. 1973)). In a scholarly analysis, Judge Stuart then determined that a plaintiff must show that a defendant banker-lender was a person who directly or indirectly controlled the primary violator *at the time of the violation*. He reasoned that a lending bank should have no higher duty and should not be subject to a more stringent test of control than a director, which again is a finding favorable to the plaintiff, for requiring a greater finding of control for a lender than a director directly charged with responsibility for the business would seem logical. He concludes that for a director or lender to be liable, it must be shown that the director or lender "exercised its power by becoming involved in the *general operations* of the corporate borrower". Judge Stuart relied upon *Stern* and *Holloway* in formulating this test, which follows the Fifth Circuit rule more favorable to plaintiffs than the stricter rule of the Second, Third and Ninth Circuits. The Eighth Circuit reviewed and adopted Judge Stuart's analysis.

Plaintiffs in the District and Circuit Courts, as well as here, rely primarily upon alleged activities of the Bank after May 10, 1974, when the violation had ceased. As bankruptcy approached and the Bank was more often in contact with its debtor, IEI, plaintiffs point to attendance at board meetings of a subsidiary and the attempts to save it from bankruptcy to show control. Plaintiffs urge this Court and urged the Courts below to adopt a test where mere unexercised and unripened power to control is alone a sufficient basis on which to posit control liability under § 20(a), even though this power to control is merely putative or contingent and can only arise in the future on the occurrence of certain events, such as declaring default and calling the loan.

This standard would make every banker-lender a controlling person unless the debtor could in fact pay off the note in full when due.

As Judge Stuart points out, any modern term loan agreement of a bank with its borrower contains numerous restrictive covenants which inevitably give a measure of control and particularly future control on the happening of certain events such as default or "calling the note". In fact, as Judge Stuart noted, every lender has some power over a borrower, particularly if the borrower does not have sufficient cash to pay off the loan when it becomes due. Every "balloon note" which has substantial amount due at the end of the term contemplates that it will be extended if interest and principal due are paid and conditions oterwise warrant extension. Congress did not intend that every lender in this situation would be a controlling person within the meaning of § 20(a), as Judge Stuart properly found.

Plaintiffs assert that "previous decisions involving lender liability under § 20(a) have not found it necessary to modify adopted standards and definitions to protect lenders". No authority is cited for this statement and none can be, as Judge Stuart correctly found that "the Court is aware of no cases in which such liability has actually been imposed on a lender". See also Lehr, *Some Securities Law Issues in Lending on Pledged Stock,* 38 Bus. Law 91 (Nov. 1982) at 191 where the author states:

> Notwithstanding assertion of pledgee voting rights, a pledgee usually does not have a direct or active relationship with the issuer. The risk of 20(a) (control) liability for the issuer's acts therefore appears minimal. *We found no case holding a pledgee liable under 20(a) for the acts of an issuer.* (Emphasis added).

It must further be noted that the Bankruptcy Judge in the IEI bandruptcy proceedings found that the IEI stock held by the Bank was held as collateral and that the Bank was not a stockholder.

Plaintiffs have admitted that the United States District Court for the Southern District of Iowa entered an Order on June 8, 1979, in the bankruptcy proceedings of Investors Equity, Inc. discussing this issue of whether or not the Bank owned the 50,000 shares of IEI stock or whether it was merely collateral for the Bank's loans to IEI. The Court found that the "put and call" arrangement is a recognized means of securing a loan and ruled that the Bank was not a shareholder but a creditor, stating:

> The parties here did not bargain for an absolute sale. Consider that the basic agreement was for a loan of money, there was more than one form of collateral taken, the stock agreement of paragraph 5 was only a portion of the contract and Investors paid "interest" on the consideration. *This was beyond question a loan and security agreement.* The underlying loan survives. (Emphasis added).

In *Sanders v. John Nuveen,* 524 F.2d 1064, 1072 (1975), the Seventh Circuit, in an opinion by Justice Stevens, discussed the question of control. It held that an underwriter was responsible for representations made in the sale of stock and has a duty to make at least some investigation into a company issuing stock which it underwrites. It further held, however, that a corporation was not in control of another corporation which controlled the underwriter by virtue of 40% stock ownership and was not liable as a controlling person for failure of the underwriter to make proper investigation of the issuer's short term commercial paper where such corporation never took any part in the management of the underwriter. Justice Stevens stated, at p. 1072:

> The situation is rather different as regards Alleghany Corporation. Alleghany is primarily an investor. Although it was in control of IDS by virtue of its 40% stock ownership and because officers and directors of Alleghany acted as officers and directors of IDS, it was never shown that

> Alleghany took any active part in the management of Nuveen; rather, it delegated this task to IDS. The judgment against Alleghany should therefore be reversed.

Here the Bank held 17% of the stock of the company as collateral, not 40% as an investment as in the *Sanders* case. here the Bank took no active part in the management of IEI. The "active part in the management" test formulated by Justice Steven in *Sanders* appears to be the same test here adopted by the District and Circuit Courts.

Despite plaintiffs' protestations, this was an ordinary lending transaction and the restrictive covenants in the loan agreement were usual and customary covenants between banker-lenders and borrowers. The Bankruptcy Court in the IEI bankruptcy and the District Court and the Eighth Circuit in this case have all found that this was a lender-borrower relationship and the latter two Courts have correctly held that the Bank was not a controlling person within the meaning of § 20(a).

CONCLUSION

As there is some difference of opinion in the Circuits as to the basis of §20(a) liability, it would be well for this Court to consider the question as well as aiding-abetting liability. It should reverse the Court of Appeals for the Eighth Circuit as to aiding-abetting liability and affirm as to control person liability.

Respectfully submitted,

Bennett A. Webster
Robert A. Gamble
Karen J. Lamp

GAMBLE, RIEPE, WEBSTER,
DAVIS & GREEN
2600 Ruan Center
Des Moines, Iowa 50309
Telephone: (515) 243-6251
Attorneys for Cross-Respondent

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CLERK

No. 85-762

In The

Supreme Court of the United States

October Term, 1985

Thelma T. Metge, Executrix of the Estate of August Metge, and Elizabeth G. Shepard on behalf of themselves and on behalf of all others similarly situated,

Cross-Petitioners,

vs.

Bankers Trust Company,

Cross-Respondent.

On Cross-Petition For A Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit (Cross-Petition to No. 85-555, October Term, 1985)

CROSS-PETITIONERS' REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

W. Don Brittin, Jr.
Gerald J. Newbrough
Kasey W. Kincaid
Nyemaster, Goode, McLaughlin, Emery & O'Brien
Tenth Floor - Hubbell Building
Des Moines, Iowa 50309
(515) 283-3100

Attorneys for Cross-Petitioners

COCKLE LAW BRIEF PRINTING CO., (800) 835-7427 Ext. 333

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Section 20(a), Securities Exchange Act of 1934, 15 U.S.C. §78t ..... *passim*

No. 85-762

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—o—

CROSS-PETITIONERS' REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

—o—

The Brief in Opposition filed by Bankers Trust Company (BTC) contains several inaccuracies concerning the contentions and evidence presented in this case. At least some of these statements must be corrected if the Court is to have a proper understanding of the issue presented in the Cross-Petition.

At issue in this Cross-Petition is the proper standard for determining whether a secondary defendant had control over a primary defendant under section 20(a) of the Securities Exchange Act. By adopting a standard that requires proof of the secondary defendant's actual *exercise* of control over the *general operations* of the primary defendant, the Court of Appeals places itself in direct conflict with numerous judicial decisions, as well as the SEC definition of "control", which provide that the *power to control* the affairs of the primary defendant is sufficient to establish a prima facie case of control. Whether a secondary defendant must be a "culpable participant" in the underlying violation is not at issue here; both the District Court and Court of Appeals correctly concluded that culpable participation is not a prerequisite to control, and the propriety of that decision has not been challenged in this Court.

In demonstrating the existence of BTC's power to control the affairs of IEI[1], the primary violator, Plaintiffs rely upon complicated and voluminous facts, circumstantial evidence and permissible inferences. These facts are set forth in Plaintiff's Brief in Opposition (adopted by reference in Plaintiff's Cross-Petition) and, contrary to BTC's assertion, are fully supported by the record: Plaintiffs filed an appendix in excess of 2400 pages with the Court of Appeals and documented their lower court briefs with a multitude of references to the record. BTC makes several misstatements concerning these facts.

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[1]Plaintiffs use the same names and terms of art in this Reply as in their prior filings in this case.

BTC contends that Plaintiffs hinge section 20(a) control on so-called "boiler-plate" loan agreement provisions. This claim is inaccurate. First, some of the loan agreement provisions were, by BTC's admission, more bizarre than boiler-plate, *e.g.*, loan agreement provisions relating to the MIL Proxy, the "put", the public-offering covenant and the IEI Stock. Second, Plaintiffs do not contend that typical loan agreement provisions, such as borrowing restrictions, are *per se* determinative of control. Nor should they be. They are, however, part of the total circumstance of control and are at least probative of control. This is especially true when their purpose is atypical, such as with the loan restrictions added by BTC to prevent IEI, a borrower in dire need of operating capital, from securing additional financing unless BTC received the proceeds. Boiler-plate loan provisions can be very powerful when the borrower's existence and the lender's hopes for repayment are dependent on them, especially when the lender believes that a borrower's primary lender "can assert any kind of pressure" it wishes.

BTC also asserts that "Plaintiffs *rely primarily* upon events which occurred several months after the sale of Thrift Certificates ceased on May 10, 1974 [to establish control]." (BTC Brief in Opposition, p. 3.) This assertion is erroneous. Plaintiffs acknowledge, and have always acknowledged, that section 20(a) liability is predicated on the power to control *during the period of the primary violations*. The record is replete with documents and events existing and occurring while the Thrift Certificates were being sold which combine to establish control. (See Statement of Facts at pages 6-18 of Plaintiffs' Brief in Opposition, incorporated in Plaintiffs' Cross-Petition for Writ

of Certiorari.) Plaintiffs have also always urged the relevance of certain matters existing and occurring before and after the sale of the Thrift Certificates as *probative* of BTC's control *during the period of the Thrift Certificate sales.* (See Statement of Facts at pages 2-5 & 18-19 of Plaintiffs' Brief in Opposition, incorporated in Plaintiffs' Cross-Petition for Writ of Certiorari.) For instance, BTC's knowledge and its active exercise of control just before and just after IEI's 3½-year securities fraud emanate from the same or related borrowers, loans, documents, collateral and lender-borrower relationships as those existing at the time of the securities fraud, and are therefore certainly probative of BTC's power, knowledge, motives, abilities, inclinations, character and scienter during the intervening securities fraud. In other words, Plaintiffs do not rely primarily on events occurring before and after the sale of Thrift Certificates to establish section 20(a) control; rather, pre- and post-violation events and documents are only offered because they are probative of BTC's control during the period of the securities fraud.

BTC tells this Court that "[*all*] of IEI's officers and directors *testified in detail* that [BTC] did not concern itself with the day-to-day operations of [IEI] and was not in control either of the Thrift Certificate program or [IEI] itself." (BTC's Brief in Opposition, p. 3.) This is similar to what BTC told the Eighth Circuit, that is "[*E*]*veryone* of the Defendants, the directors and officers of IEI *positively stated* that BTC had no knowledge whatsoever of the Thrift Certificate program and did not participate in it in any way." Contrary to these statements, the record discloses a very constant, intimate and symbiotic relationship between BTC and IEI. Also, BTC

takes unfair liberties with the testimony of IEI's officers and directors regarding the Thrift Certificate program. During depositions these people were asked by BTC's counsel if they *knew of any facts* to support *allegations* that BTC was an *"initiating force" behind the sale of Thrift Certificates*, that BTC had participated in "the *promotion of the sale" of Thrift Certificates* or that BTC had attended meetings "where the *major discussion revolved around the sale" of Thrift Certificates*. Each officer/director answered "no", that is, that he had no knowledge of any facts regarding those very specific allegations—allegations which have never been made by Plaintiffs and which are not necessary to Plaintiffs' section 20(a) claim. This testimony is qualitatively quite different than BTC claims it to be.

BTC argues that because it was only a pledgee of the IEI Stock, as opposed to an owner, it could not be a controlling person of IEI. (BTC's Brief in Opposition, p. 6.) This hypothesis conveniently ignores the numerous other indicia of control. It also conflicts with the district court's finding "that legal title to the [IEI Stock] passed to BTC's nominee, giving BTC the power to vote 17-18% of the common stock of IEI," 577 F. Supp. 810, 813, a finding shared by the Court of Appeals. 762 F.2d 621, 626. It also promotes form over substance when the real and ultimate issue is the power to control occasioned by the IEI Stock. Finally, BTC misinterprets the Bankruptcy Judge's ruling in IEI's bankruptcy proceeding. The issue before the bankruptcy court was whether the "put" (IEI's obligation to pay a specific sum for the then worthless IEI Stock) was a provable claim entitled to share in the general assets of the bankruptcy estate. The issue was not whether

BTC owned the IEI Stock or whether the IEI Stock was collateral for BTC loans. The Bankruptcy Judge merely ruled that the "put" was a provable claim. He *did not* rule that BTC was not the owner of the IEI Stock. He would have known that an underlying premise of every put obligation is that the optionee (BTC) has title to the underlying securities (IEI stock) so it can pass title to the optionor (IEI) if the put is exercised.

These facts, taken together with the voluminous additional record evidence, were sufficient to generate a genuine issue of material fact concerning BTC's control over IEI. By focusing only on proof of the actual exercise of control over IEI's general corporate operations, however, the District Court and Court of Appeals have adopted an unjustifiably restrictive standard that requires courts to ignore the numerous other indicia of control which may be present in a given case.

In contending that this restrictive standard is correct, BTC relies upon *Sanders v. John Nuveen & Co.*, 524 F.2d 1064 (7th Cir. 1975), *vacated and remanded*, 425 U.S. 929 (1976). This reliance is misplaced. In *Sanders*, the primary defendant, Nuveen, acted as the underwriter for securities sold in violation of Rule 10b-5 and was held to be primarily liable under Rule 10b-5 for its own misrepresentations and its failure to properly perform its underwriting duties. The district court also held that three other corporations controlled Nuveen and were secondarily liable to the plaintiffs as controlling persons under section 20(a). As to defendant Investors Syndicate of America, which owned 100% of the voting stock of Nuveen, and the more remote Investor Diversified Services, which owned 100% of the voting stock of Investors Syndicate

of America, the Court of Appeals affirmed the district court's finding of secondary liability. As to the very remote Alleghany Corporation, however, which owned 40% of the voting stock of Investors Diversified Services, the Court of Appeals reversed. Control of Nuveen was assumed by the Court of Appeals all the way up the corporate family tree, but Alleghany was exonerated because it "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation". Alleghany's lack of participation in the management of Nuveen did not mean it did not have control over Nuveen; rather, this lack of participation became significant with respect to the statutory defense of good faith and non-inducement. In other words, Alleghany was a controlling person even though it only owned 40% of the 100% owner of the 100% parent of Nuveen, but was exonerated after a trial on the merits because it met its statutory affirmative defense of good faith and non-inducement.

Thus, *Sanders* is consistent with Plaintiffs' position and the weight of authority. Actual exercise of control over the general operations of the primary violator is not a condition precedent to a finding of control. While it may be a factor in determining the presence of control, and while it will of course be of significance in connection with the affirmative defense of good faith and non-inducement, actual exercise of control over general operations is not, and should not be, a prerequisite to a finding of control.

BTC also misinterprets Plaintiffs' statement that "[p]revious decisions involving lender liability under section 20(a) have not found it necessary to modify accepted standards and definitions to protect lenders." (Cross-

Petition at p. 11.) This statement is completely accurate and does not carry with it any suggestion that any other lender has been held liable under section 20(a). BTC's conduct and relationship with its borrower is far different than actions of lenders in other cases. The point is that a special rule of control for lenders, such as that imposed by the lower courts in this case, is not needed and was not authorized by Congress.

This litigation has been pending since 1979. The Court of Appeals correctly concluded that Plaintiffs have generated genuine factual issues concerning BTC's liability as an aider and abettor, and Plaintiffs are anxious to proceed to trial on this claim. Should this Court grant BTC's petition for certiorari on aiding and abetting liability, however, Plaintiffs believe plenary consideration must also be given to the conflicts created by the Court of Appeals' unduly restrictive standard of control under section 20(a).

Respectfully submitted,

W. Don Brittin, Jr.
Gerald J. Newbrough
Kasey W. Kincaid
Nyemaster, Goode, McLaughlin,
Emery & O'Brien
Tenth Floor - Hubbell Building
Des Moines, Iowa 50309
(515) 283-3100

Attorneys for Cross-Petitioners